88-922

No.

Supreme Court, U.S.
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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1988

KATHRYN A. HEILY,
Petitioner,

VS.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., et al.
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE CALIFORNIA COURT OF APPEAL, FIRST APPELLATE DISTRICT

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QUESTIONS PRESENTED

A.

When a state court plaintiff presented sworn evidence of actual bias against her by the New York Stock Exchange ("NYSE") arbitration forum, and invoked general state law unconscionability principles of contracts and equity to resist the defendants' motion to compel such an arbitration of her state law wrongful discharge and other claims, did the court below, following the Ninth Circuit in *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988), correctly refuse to hear such evidence by holding that the Federal Arbitration Act, 9 U.S.C. § 2 ("FAA"), completely pre-empts any such state law challenges to the fairness of the prospective arbitration?

B.

Assuming that this Court's recent decision in *Perry v. Thomas*, 482 U.S. ____, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987), rejects any such sweeping pre-emption, does the FAA preserve petitioner's specific challenges on the basis of (1) state law unconscionability principles, as applied to the arbitral forum selection provisions of the contract; (2) state law equitable principles of unclean hands, as applied to the respondents' prehearing conduct below which undermined the integrity of an NYSE arbitration in this particular case; or (3) state law principles of fraud in the inducement to the contract?

C.

Even if all of petitioner's state law challenges are pre-empted, is the order compelling an NYSE arbitration in this case reconcilable with the FAA itself, and if not then with due process principles, where five experienced NYSE arbitrators submitted declarations stating that wrongful termination claimants against NYSE members could not obtain a fair NYSE arbitration hearing; where respondents forwarded those declarations to the NYSE; where all five declarants were immediately terminated by the NYSE as arbitrators; where the NYSE's director of arbitration—the same person who will select the NYSE arbitrators herein—submitted a declaration against petitioner in the proceedings below; and where the NYSE itself has launched an investigation of petitioner concerning the subject matter of the instant litigation?

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PETITION FOR WRIT OF CERTIORARI TO THE CALIFORNIA COURT OF APPEAL, FIRST APPELLATE DISTRICT

PARTIES

The parties to the proceeding below are petitioner Kathryn A. Heily, and respondents Merrill Lynch, Pierce, Fenner & Smith, Inc., Paul F. Hayes, and Peter S. Sansevero.

OPINION BELOW

The opinion below is reprinted in the Appendix. It has been certified for publication, and appears in the California Advance Sheets as *Heily v. Superior Court*, 202 Cal.App.3d 255 (1988), *review denied.* (Appendix A)

SUPREME COURT JURISDICTION

The opinion of the California Court of Appeal was filed on June 20, 1988. A petition for review was filed on June 29, 1988, and review was denied by the California Supreme Court on September 1, 1988. This petition is therefore timely under 28

U.S.C. § 2101(c), and jurisdiction lies because petitioner has been placed "effectively out of court," *Idlewild Liquor Corp. v. Epstein*, 370 U.S. 713, 715 n.2, 82 S.Ct. 1294, 8 L.Ed.2d 794 (1962), by the highest court of the State of California in which a decision could be had. 28 U.S.C. 1257.

STATUTES INVOLVED

(1) *9 U.S.C. § 2*

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

STATEMENT OF THE CASE

1. Proceedings In The Trial Court

Petitioner, Kathryn A. Heily ("Heily"), brought this action in the Superior Court of the State of California, naming respondents Merrill Lynch, Pierce, Fenner & Smith and several individuals (together, "Merrill Lynch") as defendants. The pertinent pleading at the time of the decision below was Heily's Second Amended Complaint ("complaint"), filed on April 23, 1987.

The complaint alleged that Heily worked as a stockbroker for Merrill Lynch for over 18 years, with an unblemished record. Starting in 1985, Merrill Lynch ordered Heily to deceive her client/investors about losses they had suffered in an investment program sponsored by Merrill Lynch. When she refused to take part in this deception, Merrill Lynch unlawfully withheld her commissions and demanded that she reimburse her investors for their losses with her personal funds. Merrill Lynch threatened her with financial ruin, and called her a liar in an attempt to

intimidate her into participating in the deception against her clients. Finally, she was fired.

Heily's complaint asserted California state law theories of wrongful termination, breach of contract, defamation, willful failure to pay her wages, and fraudulent inducement and undue influence to agree to the arbitration clauses. Because she suffered personal financial losses in the Merrill Lynch investment scheme, her complaint also alleged a common law cause of action against Merrill Lynch for negligence. (Exhibit 1)[1]

Following initial discovery, on March 6, 1987 Merrill Lynch filed a petition in the Superior Court to compel arbitration before the New York Stock Exchange ("NYSE") or the National Association of Securities Dealers ("NASD"). The petition was based on arbitration clauses in Heily's applications for approval of employment, required for registration with the NYSE, and in an option agreement Heily had signed with Merrill Lynch. (Exhibit 2)

Heily opposed the motion to compel arbitration on a number of grounds. She asserted that enforcement of the arbitration clauses at issue would be unconscionable under California law, because the forums in which Merrill Lynch sought arbitration were actually biased in favor of Merrill Lynch. She further contended that Merrill Lynch should be barred from seeking specific performance of the arbitration clauses by reason of its unclean hands in the course of seeking arbitration. In addition, she argued that the arbitration clauses were unenforceable because of fraud and undue influence in their inducement.

In support of her contentions, Heily submitted sworn declarations by five highly experienced and well respected securities industry arbitrators for the NYSE and NASD. Together, they had conducted over 300 arbitrations. Their declarations stated that NYSE arbitrations were biased against employees in disputes with securities industry employers. (Exhibit 4) This conclusion was supported by specific references to the composition of panels,

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[1] Exhibits to the petition below to the California Court of Appeal for a writ of mandate or prohibition will be referred to as "Exhibit __".

the industry and management bias of the arbitrators, the arbitrators' interest in a favorable reputation with brokerage houses, and the general interdependence and business connections necessary to succeeding in this industry.

Merrill Lynch not only defended the NYSE arbitration but concedes that it immediately sent the five declarations to the NYSE and NASD. It notified both organizations that the declarants had "attacked" the arbitration process. Within six hours after the declarations were received, all five arbitrators were terminated. An NASD witness admitted in deposition that the arbitrators were fired because they had submitted their declarations in this case. (Exhibit 5)

The Director of NYSE Arbitration, at Merrill Lynch's request, compiled statistics and submitted a declaration in support of the Merrill Lynch motion in this action. (Exhibit 5) This is the same Director who, under NYSE Rules, is directly responsible for hand-picking the arbitrators who would decide Heily's fate in NYSE arbitration. (Exhibit 2)

A 30-year employee of Merrill Lynch, one of Heily's former co-workers, testified in deposition that he had been told, by a Merrill Lynch officer, that if it could be documented that the employee had provided assistance to Heily in her suit, he would be fired, too. (Exhibit 4)

The trial court refused to consider Heily's evidence. It accepted Merrill Lynch's argument that the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.* ("FAA") pre-empts all state law challenges to the arbitrability of claims subject to the FAA.

> MR. STEPHENS [counsel for Heily]: Your Honor, we have submitted the declarations from five arbitrators from the New York Stock Exchange, the American Stock Exchange, and NASD.
>
> THE COURT: I read every word of those and it was real interesting and I got out of the market immediately. But under Federal law, it's an appropriate forum.

> If I find that the contract itself is enforceable, *I don't think, as a State court, I can even look at that*. . . . (Exh. 10) (Emphasis added)

Thus, the trial court entered an order compelling arbitration before the NYSE, and staying proceedings in the state court, on July 6, 1987. (Appendix B)

Heily then moved for reconsideration, on the basis of recently discovered evidence that the NYSE had lodged an investigation of her in connection with the same investment losses involved in the instant case. Heily also requested the court, in the alternative, to consider ordering the arbitration to be conducted by the American Arbitration Association ("AAA"), rather than the NYSE. Heily based this request on the evidence of the clear bias by the NYSE towards her individually. Heily submitted a declaration of the Regional Director of the AAA, confirming that the AAA was qualified to arbitrate all of Heily's claims against Merrill Lynch. (Exhibit 7)

At the hearing, the court again refused to consider Heily's evidence as a basis for either rejecting arbitration or ordering an alternate forum. The court believed that it had no power to do so in light of this Court's recently decided opinion in *Perry v. Thomas*, as shown by the transcript of proceedings.

> MR. STEPHENS: . . .
>
> It is your Honor's choice. The contract doesn't mandate that choice.
>
> THE COURT: I don't agree with you. I don't think I have got that choice. After *Perry*, I don't think I have got that choice. Federal law, . . . as to the enforceability of forum selection clauses is pretty clear.

Later in the hearing, the Court again opined that it did not believe it had the authority:

> MR. STEPHENS: . . .
>
> What we have presented Your Honor with is the up front evidence from 5 different arbitrators, to the effect that their experiences in all of these disputes put together, tell them

> that in this kind of a dispute, a wrongful termination case, there is unfortunately a bias that exists against the Plaintiff. And why incur that risk? Someone with an 18 year career is entitled to the limited benefit of an impartial hearing. And that is all that is being requested here, the particular forum, which Your Honor has the power to do.
>
> THE COURT: I don't agree that I do.... (Exhibit 11)

Accordingly, the court again ordered Heily to arbitrate her claims before the NYSE. (Appendix C)

2. The Appellate Proceedings –

Heily filed a petition for a writ of mandate or prohibition from the California Court of Appeal for the First District. Her petition was summarily denied, and she sought a review before the California Supreme Court. The Court granted review, but re-transferred the case to the Court of Appeal with instructions to hear the matter on the merits. (Appendix D) Following briefing, the Court of Appeal denied Heily's petition. (Appendix A)

In a sweeping ruling, the Court of Appeal held that, in light of the Ninth Circuit's opinion in *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988), under no circumstances can federal *or* state courts entertain challenges raising bias of NYSE or NASD arbitration panels, irrespective of whether the challenge is based on presumptive bias or actual bias. Furthermore, in a brief concluding paragraph, the court rejected Heily's challenges based on unclean hands and fraud in the inducement, assuming, incorrectly, that the Superior Court had ruled on those challenges on the merits.

Heily again petitioned for a review in the California Supreme Court, but this time review was denied. (Appendix "E") This petition follows.

REASONS FOR GRANTING THE WRIT

1. Notwithstanding *Perry v. Thomas*, This Court Needs To Clarify The Extent To Which The Federal Arbitration Act Pre-empts State Law Defenses To The Enforcement Of Arbitration Agreements

The opinion below dramatically demonstrates the need for further guidance from this Court regarding the interplay between federal and state law on motions to compel arbitration under the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.* ("FAA"). *Perry v. Thomas*, 482 U.S. ____, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987), seemingly preserves a significant role for state law in determining the enforceability of arbitration agreements. However, the opinion below, purporting to follow the Ninth Circuit in *Cohen v. Wedbush, Noble, Cooke, Inc., supra*, 841 F.2d 282, holds that the FAA pre-empts any state law challenges to the enforcement of arbitration agreements on the grounds that the proceeding will be unfair. Other courts have differed, as this petition will note.

In *Perry*, this Court examined a California statute exclusively addressing arbitrations. The statute, Cal. Labor Code § 229, permitted court actions to be maintained irrespective of arbitration agreements. *Perry* held that such a statute was pre-empted by the FAA.

However, *Perry* stopped well short of a conclusion that state law had no role to play in determining the enforceability of arbitration agreements. To the contrary, in a lengthy footnote, the opinion explained that the FAA did *not* pre-empt general principles of state law which might affect the enforcement of an agreement to arbitrate:

> An agreement to arbitrate is valid, irrevocable, and enforceable, *as a matter of federal law*, . . . "save upon such grounds as exist at law or in equity for the revocation of any contract." [FAA § 2] . . . Thus state law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally. A state law principle that takes its meaning precisely from the fact that a contract to arbitrate is

> at issue does not comport with this requirement (96 L.Ed.2d at 437, fn.9) (Emphasis in original.)

Thus, *Perry* seemingly reaffirmed the traditional authority of the states to apply their general legal and equitable principles to this type of dispute. Only "arbitration specific" state laws were pre-empted.

Nonetheless, in *Cohen v. Wedbush, Noble, Cooke, Inc., supra*, 841 F.2d 282, the Ninth Circuit held that the FAA did pre-empt a challenge to an arbitration based on general state law principles of unconscionability. *Cohen* reasoned that, in *Shearson/American Express, Inc. v. McMahon*, ____ U.S. ____, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987), this Court had recognized the "virtually plenary authority" (841 F.2d at 286) of the Securities and Exchange Commission ("SEC") over the arbitration procedures adopted by national securities exchanges and associations. Thus, according to *Cohen*:

> Because Congress has committed to the SEC the task of ensuring that the federal rights established by the Securities Acts are not compromised by inadequate arbitration procedures, we are bound by the Commission's determination that the procedures at issue here are satisfactory.... Any contrary holding would frustrate this carefully crafted federal regulatory scheme. (841 F.2d 286)

Cohen thus rejected state law arguments of unconscionability, stating that the "strong federal policy favoring arbitration, coupled with the extensive regulatory oversight performed by the SEC in this area, compel the conclusion that agreements to arbitrate disputes in accordance with SEC-approved procedures are not unconscionable as a matter of law." 841 F.2d at 286.

The court below, with *Cohen* as its sole authority, rejected petitioner's argument that *Perry* preserved her state law challenges to the prospective arbitration. The opinion below quotes *Perry's* choice-of-law language at length, but dismisses it as "dicta in a footnote." (A-4)

> We agree with the *Cohen* analysis. Under Cohen's interpretation of *Shearson/American Express*, the SEC is respon-

> sible for ensuring the fairness of arbitration proceedings under the NYSE and NASD. To the extent that federal or state judges, applying federal law, may have previously been permitted to entertain challenges raising institutional bias of these arbitration panels . . . , such challenges are no longer permitted. (A-8)

Other courts, however, have reached a different result. Nine days after the opinion below was first issued, California's Fourth District Court of Appeal held in *Downs v. Prudential-Bache Securities, Inc.*, 202 Cal.App.3d 616, 248 Cal.Rptr. 734 (1988), that a prospective NYSE arbitration was indeed subject to scrutiny under state law principles of unconscionability. In an opinion by Justice Patricia Benke, the court remanded the matter to permit the plaintiff to show any *actual* bias in the prospective arbitration. Interestingly, *Downs* also held that, if actual bias were found, the defendant brokerage house would nevertheless be entitled to arbitration under the rules of the American Arbitration Association—relief which petitioner sought below, as an alternative to a complete denial of respondents' motion.

In *Liddington v. The Energy Group, Inc.*, 192 Cal.App.3d 1520, 238 Cal.Rptr. 202 (1987), another California Appellate District construed *Perry v. Thomas* the way petitioner does:

> [S]o long as the state law principles in question have a general application . . . state law provides the relevant rule of law with respect to issues such as formation and enforcement of an arbitration agreement. (192 Cal.App.2d at 1527.)

In addition, the Second District Court of Appeal in *Thomas v. Perry*, 200 Cal.App.3d 510 (1988), on remand from this Court, also left the door open to challenges to arbitration based on evidence of actual bias. The court observed that the party challenging arbitration did not "suggest that he could prove actual bias." 200 Cal.App.3d at 515. Accordingly, the court followed *Cohen v. Wedbush, et al.*, and other cases finding that the NYSE rules at issue were not *presumptively* biased. Petitioner in the instant case, of course, has alleged and submitted evidence of *actual* bias.

Finally, the court below felt constrained to disregard Heily's argument based on the California Supreme Court's opinion in *Graham v. Scissor-Tail, Inc.*, 28 Cal.3d 807 (1981), on the grounds that it "directly affronts the analysis of *Perry v. Thomas* . . ." (A-5) It saw *Graham* as a "state law decision weaving together principles of adhesion contracts and state statutes governing the neutrality of arbitrators." (A-5) But it failed to apply the *Perry* analysis—to see whether the general principles of state law enunciated in *Graham* would independently support petitioner's position in the instant case.

In point of fact, *Graham's* analysis of the California doctrine of unconscionability shows that it applies generally to any kind of contract. *See also, Perdue v. Crocker National Bank*, 38 Cal.3d 913, 925, 216 Cal.Rptr. 345, 702 P.2d 503 (1985), *app. dismd. Crocker National Bank v. Perdue*, 475 U.S. 1001, 106 S.Ct. 1170 (1986), and California Civil Code Section 1670.5. In other words, the unconscionability doctrine in California is not confined to arbitration contracts. Accordingly, under *Perry v. Thomas*, the FAA does not pre-empt challenges under that doctrine, at least in the form it takes in California.

The same holds true as to petitioner's other state law challenges, invoking the general principles of unclean hands and fraudulent inducement to enter into a contract. There can be no doubt about the general applicability of the latter doctrine. As to the former, California law provides generally that is a "basic principle of equity that one who seeks equity must have clean hands; therefore a court will not aid the commission of a fraud by enforcing a contract. . . . Moreover, any unconscionable conduct in the transaction may give rise to the defense." *Taylor v. Fields*, 178 Cal.App.3d 653, 666, 224 Cal.Rptr. 186 (1986). This Court, too, has explained that "this maxim is far more than a mere banality." *Precision Instrument Manufacturing Co. v. Auto M. Machine Co.*, 324 U.S. 806, 814, 65 S.Ct. 993, 89 L.Ed.2d 1381 (1945), *reh. dend. Precision Inst. Mfg. Co. v. Auto M. Machine Co.*, 325 U.S. 893, 65 S.Ct. 1189, 8 L.Ed. 2005 (1945), and has not hesitated to close the courts of equity to those whose behavior is tainted relative to the subject matter of their equitable petition.

> [O]ne's misconduct need not necessarily have been of such a nature to be punishable as a crime or so as to justify legal proceedings of any character. Any willful act concerning the cause of action which rightfully can be said transgresses equitable standards of conduct is sufficient cause for the invocation of the maxim by the chancellor. (324 U.S. at 815)

The continued role of state law in this area is surely a "special and important reason" warranting certiorari pursuant to Supreme Court Rule 17.1.

2. This Court Needs To Reaffirm That Federal Arbitrations Must Be Fair, Whether That Fairness Is To Be Ensured Through Federal Or State Law Standards

As this Court has observed in *Commonwealth Coatings Corp. v. Continental Cas. Co.*, 393 U.S. 145, 89 S.Ct. 337, 21 L.Ed.2d 301 (1968), *reh. den. Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 1112, 89 S.Ct. 848, 21 L.Ed.2d 812 (1969), the FAA reflects "a desire of Congress to provide not merely for *any* arbitration but for an impartial one." *id.* at 147 (Emphasis in original) Due Process certainly requires no less.

Due Process requires an opportunity to be heard before an unbiased and impartial tribunal. As this Court stated in *Marshall v. Jerrico, Inc.*, 446 U.S. 238, 242, 100 S.Ct. 1610, 64 L.Ed.2d 182 (1980):

> This requirement of neutrality in adjudicative proceedings safeguards the two central concerns of procedural due process, the prevention of unjustified or mistaken deprivation and the promotion of participation and dialogue by affected individuals in the decisionmaking process. [Citation] The neutrality requirement helps to guarantee that life, liberty, or property will not be taken on the basis of an erroneous or distorted conception of the factors or the law. [Citation] At the same time, it preserves both the appearance and reality of fairness, "generating the feeling, so important to a popular government, that justice has been done," [citation] by ensuring that no person will be deprived of his interests in the absence of a proceeding in which he may present his case

> with assurance that the arbiter is not predisposed to find against him.
>
> The requirement of neutrality has been jealously guarded by this court.

Bias in an adjudicatory system is the antithesis of due process. It would be anomalous indeed if federal law mandated that evidence of bias in an arbitration system was inadmissible and beyond judicial consideration in deciding whether to compel arbitration.

This principle is more crucial today—and regrettably more in jeopardy today—in the wake of this Court's application of the FAA to the securities industry in *McMahon*. The dissenters, for example, did not share the majority's confidence in SEC oversight of such organizations as the NYSE. Justice Blackmun's dissenting opinion observed the danger that arbitrations would be in "a forum controlled by the securities industry," 96 L.Ed.2d at 215, and quoted one expert's view that the brokerage houses own a "stacked deck." *Id.* at 216.

That is the specific allegation here, and petitioner has adduced specific evidence to support it. Moreover, her claims of bias are founded not merely on the composition and procedures of the NYSE and NASD, but on their and respondents' actions in this very case.

Moreover, the ability to challenge the bias of an arbitral forum at this stage is critical. As the Third Circuit recently held in an analogous context, the decision of a biased decisionmaker is difficult if not impossible to cure on a deferential post-decision review. In *United Retail & Wholesale Emp. v. Yahn & McDonell*, 787 F.2d 128 (3rd Cir. 1986), *affirmed without opinion by an equally divided court*, ____ U.S. ____, 107 S.Ct. 2171, 95 L.Ed.2d 692 (1987), the Third Circuit struck down a section of the Multiemployer Pension Plan Amendments Act of 1980 because it deprived employees of an impartial decision maker. At issue were procedures which required the initial decisionmaker's holding to be given a deferential review by an arbitration panel. The court thus concluded that "[n]either the appearance nor

reality of fairness is served when a tainted verdict is presumed correct in subsequent review." 787 F.2d at 141.

That same deference is required on a post-arbitration review of awards under the FAA. *French v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 784 F.2d 902, 906 (9th Cir. 1986).

CONCLUSION

A grant of certiorari is appropriate in this case to define the extent to which state law applies to challenges to arbitration based on the actual bias of an arbitral forum. This case demonstrates the need for this Court to affirm that federal arbitrations must be fair, and to specify the standards by which that fairness is to be ensured. A review in this Court should therefore be granted.

Respectfully submitted,

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Appendix A

Certified for Publication

In the Court of Appeal of the State of California
First Appellate District, Division Three

Kathryn A. Heily,
Petitioner,

v.

The Superior Court of the City and
County of San Francisco
Respondent;

Merrill Lynch, Pierce, Fenner & Smith, Inc., et at.,
Real Parties in Interest

A040522
(Super. Ct. No. 868892
City and County of San Francisco)

Filed June 20, 1983

Petitioner, the plaintiff in a wrongful discharge action, challenges a court order requiring her to arbitrate her dispute under procedures established by the New York Stock Exchange (NYSE hereinafter). She contends both that her agreement to arbitrate was procured by fraud and that it should be set aside as unconscionable because of institutional bias in arbitration conducted under the auspices of the NYSE. We reject her contentions.

Petitioner has filed an action against real parties in interest, Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch hereinafeter) and two individual Merrill Lynch employees. The complaint alleges that after 18 years of service as a securities broker petitioner was discharged by real parties for failure to participate in a scheme to conceal from her clients the real reason they sustained losses in a Merrill Lynch sponsored options investment program. Merrill Lynch's position is that petitioner was discharged because she divulged confidential information about the settlement of claims for investment losses.

Shortly after petitioner filed the complaint, real parties petitioned the court for an order compelling arbitration. Real parties cited arbitration provisions in several agreements signed by petitioner during her employment with Merrill Lynch. These provisions called for arbitration under the procedures of either the NYSE or the National Association of Securities Dealers (NASD hereinafter).

Petitioner opposed the petition to compel arbitration on several grounds. She argued that the arbitration agreements were unenforceable adhesion contracts, that they were procured through fraud and use of undue influence, and that real parties could not seek an order compelling arbitration because they were barred by their "unclean hands." She presented declarations from persons who had served as arbitrators for the NASD and NYSE and who would testify that employer/employee arbitrations are biased in favor of securities industry employers. Real parties filed a reply memorandum, supported by extensive deposition testimony, documentary evidence, and declarations. Real parties also moved to strike petitioner's declarations as "speculative, hearsay, irrelevant or otherwise inadmissible." The court did not rule on the motion to strike.

After hearing, the court granted real parties' motion to compel arbitration. Petitioner then moved for reconsideration. The court heard the motion to reconsider, reexamined its ruling on the merits, and denied the motion.

Petitioner sought a writ of mandate and/or prohibition from this court. We denied the petition. Petitioner then sought review in the Supreme Court. That court granted review and retransferred the matter to this court with the following directions: "to issue an alternative writ to be heard before that court when the proceeding is ordered on calendar. (See *Tonetti v. Shirley* (1985) 173 Cal.App.3d 1144; *Marc Rich & Co. v. Transmarine Seaways Corp.* (S.D.N.Y. 1978) 443 F.Supp. 386, 388; and *Corporate Printing Co. v. N.Y. Typographical Union* (S.D.N.Y. [1984] 601 F.Supp. 323, 328, fn. 8.)" We issued the alternative writ and heard the matter. We again deny the petition.

Citing a mixture of state law and federal law decisions, petitioner contends that an agreement to arbitrate may be set aside if the designated arbitrator or arbitral body is biased or not neutral. In order to evaluate this contention we must first determine whether state or federal law controls. Recent case law has provided a clear answer.

In *Merrill Lynch, Pierce, Fenner & Smith v. Ware* (1973) 414 U.S. 117, decided without consideration of the Federal Arbitration Act (FAA), 9 United States Code section 1 et seq., the United States Supreme Court upheld application of a state law that authorized employees to bring actions to collect wages without regard to private arbitration agreements. (*Id.*, at pp. 134-140.) The *Ware* decision opened the door to arguments that state law might govern arbitrability of agreements such as petitioner's. However, in *Perry v. Thomas* (1987) 482 U.S. ____ [96 L.Ed.2d 426, 107 S.Ct. 2520], the court directly confirmed that the FAA controls lawsuits brought by employees against securities brokerage firms.

In *Perry* the employee's action arose from a dispute over commissions on the sale of securities. Relying on a signed arbitration agreement, the employer sought arbitration under the authority of section 2 of the FAA: "A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, . . . shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." (9 U.S.C. § 2.) Citing *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.* (1983) 460 U.S. 1, and *Southland Corp. v Keating* (1984) 465 U.S. 1, the *Perry* court concluded that the effect of section 2 is to " . . . 'create a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act.' [Citation.]" (*Perry v. Thomas, supra,* 482 U.S. at p. __ [96 L.Ed.2d at p. 435, 107 S.Ct. at p. 2525].)

Prior to *Perry*, state and federal courts disagreed among themselves about whether federal law governed questions of interpretation, validity and enforcement of arbitration agreements. Through

dicta in a footnote, the *Perry* court shed some light on this question: "We also decline to address Thomas' claim that the arbitration agreement in this case constitutes an unconscionable, unenforceable contract of adhesion. This issue was not decided below, see nn 4 and 6, supra, and may likewise be considered on remand. [¶] We note, however, the choice-of-law issue that arises when defenses such as Thomas' so-called 'standing' and unconscionability arguments are asserted. In instances such as these, the text of § 2 provides the touchstone for choosing between state law principles and the principles of federal common law envisioned by the passage of that statute: An agreement to arbitrate is valid, irrevocable, and enforceable, *as a matter of federal law*, see *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.* 460 US 1, 24, 74 L Ed 2d 765, 103 S Ct 927 (1983), 'save upon such grounds as exist at law or in equity for the revocation of any contract.' 9 USC § 2 . . . (emphasis added). Thus state law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally. A state law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with this requirement of § 2. See Prima Paint, supra, [Prima Paint Corp. v. Flood & Conklin Mfg. Co. (1967) 388 U.S. 395], at 404, 18 L Ed 2d 1270, 87 S Ct 1801; *Southland Corp. v. Keating* 465 US, at 16-17, n 11, 79 L Ed 2d 1, 104 S Ct 852. A court may not, then, in assessing the rights of litigants to enforce an arbitration agreement, construe that agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law. Nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what we hold today the state legislature cannot." (*Perry v. Thomas, supra*, 482 U.S. at p. __ [96 L.Ed.2d at p. 437, fn. 9, 107 S.Ct. at p. 2527]; see also *Liddington v. The Energy Group, Inc.* (1987) 192 Cal.App.3d 1520, 1527-1528.)

Petitioner argued below, and argues here too, that under *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, the NYSE, because of its status and identity, is presumptively biased in favor of real parties in interest, and that the arbitration agreement is

therefore unconscionable and should not be enforced. This argument directly affronts the analysis of *Perry v. Thomas* because *Graham* is a state law decision weaving together principles of adhesion contracts and state statutes governing the neutrality of arbitrators. (*Id.*, at pp. 820-828.) *Perry* teaches that a court may not rely upon anything that is unique to an agreement to arbitrate when assessing unconscionability of an agreement governed by the FAA. State law concerning arbitration or arbitrators cannot form a basis for evaluating state law enforceability of the contract. (Accord *Thomas v. Perry* (1988) 200 Cal.App.3d 510, 515, on remand after decision in *Perry v. Thomas, supra,* 482 U.S. ____.)

Having concentrated on state law, petitioner has ignored decisions applying federal law to questions of bias in arbitration. The California Supreme Court's retransfer order directed our attention to decisions applying federal law.

The first case cited, *Tonetti v. Shirley, supra,* 173 Cal.App.3d 1144, a California decision, explains one of the differences between state and federal law. There a stockbroker sued his employer for defamation and related causes of action. The employer sought arbitration under the rules of the NYSE, but the trial court denied the request, relying on a state law decision that found a similar brokerage/account executive contract provision unconscionable. *Tonetti* reversed, concluding that federal law preempted and that the arbitration provision was not unconscionable under federal law. (*Id.*, at pp. 1146-1147.)

The court examined California law on unconscionability of arbitration under the rules of the NYSE, noting that in *Hope v. Superior Court* (1981) 122 Cal.App.3d 147, the court had cited *Graham v. Scissor-Tail, Inc., supra,* 28 Cal.3d 807, and had concluded that the arbitration procedures of the NYSE failed to meet minimal levels of integrity. (*Tonetti v. Shirley, supra,* 173 Cal.App.3d at pp. 1149-1150.) The *Tonetti* court then found that "[i]n contrast to California's position, federal cases have held the procedures to be fair and enforceable." (*Id.*, at p. 1150.) One federal decision found the composition of the NYSE arbitration tribunal to be within the "rule of reason" and not a violation of the antitrust laws (*Drayer v. Krasner* (2d Cir. 1978) 572 F.2d 348, 360, cert. den. 436 U.S. 948), and another decision rejected

a claim of an employee-broker that the NYSE arbitration procedures were unconscionable (*Pelzman v. Paine, Webber, Jackson & Curtis, Inc.* [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99408 (D.D.C. 1983)). The *Tonetti* court concluded that unlike state law, federal law placed the burden of showing institutional bias upon the person resisting arbitration. (*Id.*, at p. 1150). "The trial court received no evidence on the actual operation of the NYSE arbitration procedures as they apply to *Tonetti*. . . . Thus, the case must be remanded so the issue of unconscionability can be properly determined under federal law and the NYSE rules as they exist at the time of the new hearing." (*Id.*, at p. 1151.)

Two other federal decisions, not mentioned by *Tonetti*, but cited in the California Supreme Court's transfer order here, show that under federal law as it was then applied, a litigant could assert bias of the arbitrator or arbitral panel as a basis for avoiding arbitration or replacing the arbitrator. In *Marc Rich & Co. v. Transmarine Seaways Corp., supra*, 443 F.Supp. 386, the court was asked to disqualify an arbitrator selected by one party because the arbitrator was currently involved in an unrelated dispute with the selector's adversary. In order to prevent repeated pre-arbitration attacks upon a party's designation of the arbitrator, the *Marc Rich & Co.* court found that it lacked jurisdiction to rule on the issue. However, in the course of its ruling, it noted that a different rule would apply if the contract had specifically named the arbitrator, as in *Erving v. Virginia Squires Basketball Club* (E.D.N.Y. 1972) 349 F.Supp. 716, 719, affirmed (2d Cir. 1972) 468 F.2d 1064, and *Siedman v. Merrill Lynch*, unreported decision (S.D.N.Y. Aug. 24, 1977) 75 Civil No. 6316. In *Siedman*, according to the *Marc Rich & Co.* court, the court found jurisdiction, prior to the commencement of arbitration, to consider the qualifications of the NYSE as arbitrator of a dispute. Subsequent history of the case reveals that though the court considered the allegation of bias, it declined to order the NYSE replaced by the American Arbitration Association as the arbitral body. (see *Siedman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (S.D.N.Y. 1979) 465 F. Supp. 1233, 1235 [Note that the court in *March Rich & Co., supra*, misspelled *Siedman* "Seidman."."].)

In *Corporate Printing Co. v. N.Y. Typographical Union, supra*, 601 F.Supp. 323, the last decision cited by the California Supreme Court's transfer order, the court also found a pre-arbitration attack upon the institutional bias of an arbitrator premature. However, a footnote acknowledged a different approach where the arbitrator was named in the agreement, citing *Erving* and *Marc Rich & Co.* (*Id.*, at p. 328, fn. 8.)

Marc Rich & Co., Corporate Printing Co., and particularly *Siedman*, show that under federal law, as it had been stated before the Supreme Court transferred this case to us, a litigant could make a pre-arbitration showing that the NYSE or other designated arbitral panel was institutionally biased, but that unlike the situation under California law, no presumption of institutional bias would obtain. But more recent 9th Circuit authority holds otherwise.

In *Cohen v. Wedbush, Noble, Cooke, Inc.* (9th Cir. 1988) 841 F.2d 282, the court rejected a challenge similar to petitioner's, finding that "agreements to arbitrate disputes in accordance with SEC-approved procedures are not unconscionable as a matter of law." (*Id.*, at p. 286.) In *Cohen*, margin account customers sought to avoid arbitration of a dispute over the broker's sale of some collateral in their margin account. Citing *Lewis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1986) 183 Cal.App.3d 1097, and *Lewis v. Prudential-Bache Securities, Inc.* (1986) 179 Cal.App.3d 935, decisions relied upon heavily by petitioner here, they argued that the arbitration agreement was unconscionable.

Because of a recent United States Supreme Court decision, *Cohen* rejected plaintiffs' contention: "We respectfully disagree, however, with the conclusion of the California courts that the doctrine of unconscionability is applicable under these circumstances. *Cf. Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334, 339 (7th Cir. 1984) (rejecting claim that agreements to arbitrate securities claims was unconscionable where plaintiffs made no showing that agreement was commercially unreasonable or that they had no reasonable opportunity to understand it). As the Supreme Court has recognized, the Securities and Exchange Commission has virtually plenary authority over the arbitration procedures adopted by the national securities exchange and secur-

ities associations. *See Shearson/American Express, Inc. v. McMahon,* ____ U.S. ____, 107 S.Ct. 2332, 2341, 96 L.Ed.2d 185 (1987). This authority includes the power to 'abrogate, add to, and delete from' the arbitration rules adopted by such bodies if necessary or appropriate to protect the rights created by the Securities Acts. *Id.*; 15 U.S.C. § 78s(c) (1982). The SEC has explicitly approved the NYSE and NASD arbitration rules and procedures at issue in this case. *McMahon,* 107 S.Ct. at 2341. Because Congress has committed to the SEC the task of ensuring that the federal rights established by the Securities Acts are not compromised by inadequate arbitration procedures, we are bound by the Commission's determination that the procedures at issue here are satisfactory. [Citation.] Any contrary holding would frustrate this carefully crafted federal regulatory scheme. [¶] Our conclusion is not affected by the Cohens' contention that the arbitration agreement is part of a contract of adhesion. We have previously held that state law adhesion contract principles may not be invoked to bar arbitrability of disputes under the Arbitration Act. *Bayma,* [*Bayma v. Smith Barney, Harris Upham & Co.* (9th Cir. 1986)] 784 F.2d [1023] at 1024-25. We reaffirm that holding today." (*Cohen v. Wedbush, Noble, Cooke, Inc., supra,* 841 F.2d at pp. 285-286, fn. omitted.)

We agree with the *Cohen* analysis. Under *Cohen's* interpretation of *Shearson/American Express* the SEC is responsible for ensuring the fairness of arbitration proceedings under the NYSE and NASD. To the extent federal or state judges applying federal law may have previously been permitted to entertain challenges raising institutional bias of these arbitration panels (as in *Siedman, supra,* for instance), such challenges are no longer permitted. We sustain the superior court's order here.

We have not addressed petitioner's assertions that there was fraud in the inducement to enter the arbitration agreements and that real parties were barred from equitable relief by their unclean hands. Though petitioner argues these issues extensively in her petition, she does so as if she were arguing them to the trier of fact, not to an appellate court. Petitioner fails to even advise this court of the considerable evidence contrary to her positions. Thus, she fails to demonstrate how the trial court abused its discretion

and why its rulings on any factual disputes were not supported by substantial evidence. We reject her claims.

The alternative writ is discharged and the petition for peremptory writ is denied.

Certified for Publication.

Merrill, J.

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Peter F. Sansevero

The Superior Court of the State of California
In and for the City and County of San Francisco

Kathryn A. Heily,
Plaintiff,

v.

Merrill Lynch, Pierce, Fenner & Smith Inc.,
Paul F. Hayes, an individual, Peter F. Sansevero,
and individual, and Does One through Fifty,
Defendants.

No. 868892

Order Compelling Arbitration and
Staying Procedures

Defendants' Petition For Order Compelling Arbitration and Motion For Order Staying Proceedings came on for hearing on June 10, 1987, W. Reece Bader and Jay M. Cutler of Orrick, Herrington & Sutcliffe appearing on behalf of the moving parties and Shand S. Stephens of Bronson Bronson & McKinnon appearing on behalf of plaintiff. The Court having considered the arguments of counsel, the memoranda, declarations, exhibits and deposition excerpts filed by the parties, and all of the pleadings and papers on file herein, and good cause appearing therefor.

IT IS HEREBY ORDERED AS FOLLOWS:

1. The Petition to Compel Arbitration before the New York Stock Exchange is granted; and

2. All proceedings herein are stayed pending arbitration.

Dated: July 2, 1987

Lucy Kelly McCabe
Judge of the Superior Court

Approved as to form:
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In the Superior Court of the State of California
In and For the City and County of San Francisco

Kathryn A. Heily
Plaintiff,

v.

Merrill Lynch, Pierce, Fenner & Smith Inc.,
Paul F. Hayes, an individual, Peter F. Sansevero,
an individual, and Does One through Fifty
Defendants.

No. 868892
Order Denying Motion for Reconsideration
of Order Compelling Arbitration

Plaintiff's Motion For Reconsideration of the Order Compelling Arbitration came on for hearing on August 25, 1987. Shand S. Stephens of Bronson, Bronson & McKinnon appearing on behalf of plaintiff and moving party and W. Reece Bader of Orrick, Herrington & Sutcliffe appearing on behalf of defendants; and the Court having considered the arguments of counsel, the memorandum, declarations and exhibits filed by the parties, and all of the pleadings and papers on file herein, and good cause appearing therefor,

IT IS HEREBY ORDERED that the Motion for Reconsideration be, and the same hereby is, DENIED.

Dated: August 25, 1987

Lucy Kelly McCabe
Judge of the Superior Court

APPENDIX D

Order Granting Review

After Judgment by the Court of Appeal
First District, Division Three, No. A040522, S003424

In the Supreme Court of the State of California

In Bank

Heily, Petitioner,

v.

Superior Court of the City and County of San Francisco,
Respondent,
Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.,
Real Parties in Interest

[Filed February 25, 1988]

Petition for review granted. The matter is transferred to the Court of Appeal, First Appellate District, Division Three, with directions to issue an alternative writ to be heard before that court when the proceeding is ordered on calendar. (See Tonetti v. Shirley (1985) 173 Cal.App.3d 1144; Marc Rich & Co. v. Transmarine Seaways Corp. (S.D.N.Y. 1978) 443 F.Supp. 386, 388; and Corporate Printing Co. v. N.Y. Typographical Union (S.D.N.Y.) 601 F.Supp. 323, 328, fn. 8.)

Chief Justice

MOSK
Associate Justice

BROUSSARD
Associate Justice

ARGUELLES
Associate Justice

EAGLESON
Associate Justice

KAUFMAN
Associate Justice

Associate Justice

Order Denying Review

After Judgment by the Court of Appeal

1st District, Division 3, No. A040522, S003424

In the Supreme Court of the State of California

In Bank

Kathryn A. Heily, Petitioner,

v.

Superior Court of the City and County of San Francisco,
Respondent;

Merrill Lynch, etc., et al.,
Real Parties in Interest.

[Filed September 1, 1988]

Petition for review Denied.

LUCAS
Chief Justice